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**CITY OF DALY CITY
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS**

**FOR THE YEAR ENDED
JUNE 30, 2009**

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**CITY OF DALY CITY
MEMORANDUM ON INTERNAL CONTROL
AND
REQUIRED COMMUNICATIONS**

For the Year Ended June 30, 2009

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ACCOUNTANCY CORPORATION
3478 Buskirk Ave. - Suite 215
Pleasant Hill, California 94523
(925) 930-0902 • FAX (925) 930-0135
maze@mazeassociates.com
www.mazeassociates.com

MEMORANDUM ON INTERNAL CONTROL

October 23, 2009

To the City Council of
the City of Daly City, California

In planning and performing our audit of the financial statements of the City of Daly City as of and for the year ended June 30, 2009, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the City's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the City's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, we noted no matters that we consider to be material weaknesses.

Included in the Schedule of Other Matters are recommendations not meeting the above definitions that we believe to be of potential benefit to the City.

The City's written responses included in this report have not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This communication is intended solely for the information and use of management, City Council, others within the organization, and agencies and pass-through entities requiring compliance with generally accepted government auditing standards, and is not intended to be and should not be used by anyone other than these specified parties.

Maze & Associates

**CITY OF DALY CITY
MEMORANDUM ON INTERNAL CONTROL**

SCHEDULE OF OTHER MATTERS

New Pronouncements:

The following comments represent new pronouncements taking affect in the next few years. We cite them here to keep you abreast of developments:

2009-01 - Upcoming GASB Statement No. 51, Accounting and Financial Reporting for Intangible Assets (Effective for fiscal 09/10) - Retroactive Application Required

Governments have different types of intangible assets, such as easements, water rights, capacity rights, patents, trademarks, and computer software. The objective of this Statement is to establish accounting and financial reporting requirements for intangible assets to reduce inconsistencies and enhance comparability. Retroactive reporting is required for intangible assets acquired in fiscal years ending after June 30, 1980.

Management Response:

The City is unaware of holding any intangible assets that would fall under this pronouncement.

2009-02 - Statement No. 53 - Accounting and Financial Reporting for Derivative Instruments (Effective for fiscal 09/10)

This Statement is intended to improve how state and local governments report information about derivative instruments in their financial statements. Specifically, GASB 53 requires governments to measure most derivative instruments at fair value in their financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting (proprietary and entity-wide financial statements). Governments enter into derivative instruments as investments; as hedges of identified financial risks associated with assets or liabilities, or expected transactions (that is, hedgeable items); or to lower the costs of borrowings. Governments often enter into derivative instruments with the intention of effectively fixing cash flows or synthetically fixing prices. Common types of derivative instruments used by governments include interest rate and commodity swaps, interest rate locks, options (caps, floors, and collars), swaptions, forward contracts, and futures contracts. In addition, this standard addresses hedge accounting requirements.

Management Response:

The City does not hold derivative investments, but should it do so in the future we will report as required by GASB 53.

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SCHEDULE OF OTHER MATTERS

2009-03 - GASB Statement No. 54 Fund Balance Reporting and Governmental Fund Type Definitions (Effective for fiscal 10/11)

This Statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds.

The initial distinction that is made in reporting fund balance information is identifying amounts that are considered **nonspendable**, such as fund balance associated with inventories. This Statement also provides for additional classification as **restricted, committed, assigned, and unassigned** based on the relative strength of the constraints that control how specific amounts can be spent.

The **restricted** fund balance category includes amounts that can be spent only for the specific purposes stipulated by constitution, external resource providers, or through enabling legislation.

The **committed** fund balance classification includes amounts that can be used only for the specific purposes determined by a formal action of the government's highest level of decision-making authority. Amounts in the **assigned** fund balance classification are intended to be used by the government for specific purposes but do not meet the criteria to be classified as restricted or committed. In governmental funds *other than the general fund*, assigned fund balance represents the remaining amount that is not restricted or committed.

Unassigned fund balance is the residual classification for the government's general fund and includes all spendable amounts not contained in the other classifications. *In other funds*, the unassigned classification should be ***used only to report a deficit balance*** resulting from overspending for specific purposes for which amounts had been restricted, committed, or assigned. Governments are required to disclose information about the processes through which constraints are imposed on amounts in the committed and assigned classifications.

Disclosure of the policies in the notes to the financial statements is required.

This Statement also provides guidance for classifying stabilization amounts on the face of the balance sheet and requires disclosure of certain information about stabilization arrangements in the notes to the financial statements.

The definitions of the general fund, special revenue fund type, capital projects fund type, debt service fund type, and permanent fund type are clarified by the provisions in this Statement. Interpretations of certain terms within the definition of the special revenue fund type have been provided and, for some governments, those interpretations may affect the activities they choose to report in those funds. The capital projects fund type definition also was clarified for better alignment with the needs of preparers and users. Definitions of other governmental fund types also have been modified for clarity and consistency.

Management Response:

The City intends to comply.

**CITY OF DALY CITY
MEMORANDUM ON INTERNAL CONTROL**

STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2008-01: San Mateo County Investment Pool Fair Value and Credit Risks

At June 30, 2008, the City, including its component unit, the Daly City Redevelopment Agency, had \$35.3 million of investments in the San Mateo County Investment Pool. Subsequent to June 30, 2008, the City was informed that management of the San Mateo County Investment Pool removed certain investments issued by Lehman Brothers Holdings, Inc. (Lehman Brothers) from the Pool and classified them as non-performing assets due to the bankruptcy filed by Lehman Brothers. This write down reflects concerns that those investments may not be collectable. Ultimate recovery, if any, is not determinable at this time. At September 30, 2008, the City's share of the loss is estimated to be \$1.7 million.

The federal government has taken steps to support financial markets in an effort to stave off further negative trends. The recent market conditions have increased credit risks which warrant continuous monitoring and reassessment of investment risks. The City should place the highest priority on monitoring all its investments and formulate investment contingency plans as needed.

Management Response:

Vigilant oversight of the City's investment portfolio has been a hallmark of our investment program over many years. The City adheres to the prudent investment doctrine of safety, liquidity, yield, in that order of importance. As unfortunate as the Lehman bankruptcy was, it was also unanticipated by anyone in the financial community. Such an occurrence emphasizes the need for adequate and well thought out investment policies. However, even with such policies in place it is impossible to protect against all risk. Such, we believe, is the situation here. That said, the City has moved toward a more diversified portfolio and will continue to monitor investments carefully.

2008-02: Certificate of Deposit Investments

As of June 30, 2008, the City invested in 12 Certificates of Deposit (CD's) in the total amount of \$32,897,000 with six different banks. Certificates of Deposit are FDIC insured for up to \$100,000 per CD, thus exposing the City to potential significant credit risk.

The City should consider also investing in the Certificate of Deposit Account Registry System (CDARS). CDARS is a private CD placement service that allows local agencies to purchase more than \$100,000 in CD's from a single financial institution (that participates in CDARS) while still maintaining FDIC insurance coverage. CDARS facilitates the trading of deposits between the California financial institution and other participating institutions in amounts that are less than \$100,000 each, so that FDIC coverage is maintained. Under California Government Code 53601.8, investment in a CD placement service is limited to 30% of the portfolio.

Currently the City's investment policy Section V (A) (1) prohibits dealing with financial institutions that do not have an office in California. If the City decides to invest in CDARS, the investment policy may need to be amended to allow dealing with financial institutions that do not have an office in California. The City will also need to include the CD placement service as one of its authorized investments in the investment policy if the City decides to participate in the CD placement service.

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STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

Management Response:

The City is continuing a process of diversifying its investments with the intent to limit risk. We have investigated CDARS, but have determined that although it is a convenient option there are other options with equal security that will yield a higher rate of return. As an example, individual placement of CDs with financial institutions that are well rated and in an amount that falls within FDIC insurance limits yield rates high enough that it is worth the effort in placing the individual CDs.

2008-03: Information Technology Best Practices Recommendations

We conducted an Information Systems Review with our audit which encompassed the financial information system and the network environment that houses it. We expanded our work from previous years beyond simply looking at financial information systems as a result of greater risks of unauthorized access caused by overall industry growth of web-based commerce and internet based financial systems. Internal controls that are present in the overall network environment have become more important and relevant to understanding the internal controls over the financial system. We believe Information System controls must be continuously improved and enhanced to stay ahead of the ever increasing sophistication of hackers and criminals.

Currently, there are no Information Technology standards which local governments are required to conform to. Indeed there are a wide variety of informal guidelines and suggested controls from many different organizations which local governments can use to implement appropriate controls to ensure adequate security over information technology. Our Information Technology staff have reviewed these informal guidelines and concluded that the certification and accreditation framework developed by the National Institute of Standards and Technology (NIST) for the Federal Information Security Management Act (FISMA) are the most appropriate for local government. NIST and FISMA represent the minimum security requirements for federal government agencies information systems. We understand the U.S. Department of Justice recommends these for local governments. Our procedures included performing an external network scan based on NIST criteria and in determining that internal control provides for:

- Internet access defenses including hacker prevention, detection and deterrent systems
- Security of data from physical or network access
- Adequately protecting data from unauthorized internal access
- Reasonable measures to ensure continuation of service

While the results of our work did not indicate material weaknesses or significant exploitable vulnerabilities, we did note a few areas which could be improved to conform to NIST guidelines. A summary of these recommendations which we believe are "best practices" are as follows:

- *Payment Card Industry Compliance* - Any organization that processes credit cards is required to comply with the Payment Card Industry Data Security Standard (PCI-DSS), even if the processing is outsourced. The standard was developed to minimize the risk of loss due to security breaches in processing credit card transactions. Merchants which conform to the Standard pay lower transaction fees and minimize their liabilities which may result from security breaches than those that do not comply. The Standard requires varying levels of controls depending on transaction levels. In general, merchants must:
 1. Fill out a self-assessment questionnaire (SAQ).
 2. Submit the SAQ to acquiring banks.
 3. Perform quarterly external network scans and submit the results to acquiring banks.
 4. Have a full independent PCI audit performed by a Qualified Security Assessor (QSA) and submit it to acquiring banks. (Required for level 1 merchants only).

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STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

We believe the City qualifies as a Level 3 or 4 merchant due to activity levels of less than 1 million transactions and currently it need only complete and maintain the SAQ in-house. However, we understand SAQ submissions will become mandatory for Level 3 and 4 merchants within the near future.

We understand that the City is working on its compliance with the PCI-DSS. We recommend the City continue to do so and perform a compliance review annually.

- *General Information Systems Controls* - We compared the City's information systems controls with the various NIST standards and believe improvements should be considered for implementation such as employing Audit/Event logging, contingency planning and training and other areas. We have provided a detailed report to the City's Finance Staff which describe the control standards and the current status for their consideration.

As noted above, the City is not required to conform to NIST standards and could use another set of guidelines to ensure the adequacy of controls. However, we recommend the City select an appropriate industry standard such as NIST to plan, organize and monitor information security proactively.

- *Audit/Event Logging* - We believe this is one of the more important standards of NIST. The City does not appear to have audit logs on the financial application server, such that any change, addition or deletion of user accounts within the application are tracked and monitored. The City should have audit/event logs of any addition, deletion or change in financial application user accounts and that log should be monitored by someone without the rights to effect such changes. In addition, any administrative access such as upgrades or application modifications by IT personnel, outside consultants or vendors should also be logged and reviewed.

Management Response:

As noted above, the City continues to work on compliance with industry standards for information systems security. We work closely with our bank to insure we meet their requirements, and will continue to do so in the future. We have in the past discussed event logging with our software vendor, and have been told that the effect on server resources would be severe. We recognize the value of such reporting and are exploring options with our vendor to put such reporting efficiently in place.

MAZE & ASSOCIATES

ACCOUNTANCY CORPORATION
3478 Buskirk Ave. - Suite 215
Pleasant Hill, California 94523
(925) 930-0902 • FAX (925) 930-0135
maze@mazeassociates.com
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REQUIRED COMMUNICATIONS

October 23, 2009

To the City Council of
the City of Daly City, California

We have audited the financial statements of the City of Daly City as of and for the year ended June 30, 2009 and have issued our report thereon dated October 23, 2009. Professional standards require that we advise you of the following matters relating to our audit.

Financial Statement Audit Assurance: Our responsibility, as prescribed by professional standards, is to plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit in accordance with generally accepted auditing standards does not provide absolute assurance about, or guarantee the accuracy of, the financial statements. Because of the concept of reasonable assurance and because we did not perform a detailed examination of all transactions, there is an inherent risk that material errors, fraud, or illegal acts may exist and not be detected by us.

Other Information Included with the Audited Financial Statements: Pursuant to professional standards, our responsibility as auditors for other information in documents containing the City's audited financial statements does not extend beyond the financial information identified in the audit report, and we are not required to perform any procedures to corroborate such other information. Our responsibility also includes communicating to you any information that we believe is a material misstatement of fact. Nothing came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial statements. This other information and the extent of our procedures is explained in our audit report.

Accounting Policies: Management has the responsibility to select and use appropriate accounting policies. A summary of the significant accounting policies adopted by the City is included in Note 1 to the financial statements. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2009. As described in notes to the financial statements, during the year, the City implemented the following new accounting standards:

- **GASB Statement No. 45 - Accounting And Financial Reporting By Employers For Postemployment Benefits Other Than Pensions**

GASB 45 uses Pension Accounting (GASB 27) to change the accounting for Other Post Employment Benefits (OPEB) to full accrual at the Entity-wide and proprietary funds financial statement levels. Under the concepts in GASB 45 an actuarial study or simplified measurement method calculation is performed to determine an Annual Required Contribution (ARC). So long as employers contribute this amount every year, no accrual adjustment is needed in the financial statements. A summary of the impacts of this statement are presented below:

As discussed in Note 8 to the financial statements, during the year ended June 30, 2009, the City contributed less than the ARC for fiscal 2009. The remaining ARC (termed Net OPEB Obligation) has been recorded as a liability and is being amortized over the actuarial amortization period in accordance with GASB 45 requirements. There was no cumulative effect of the accounting change as of the beginning of the year.

Unusual Transactions, Controversial or Emerging Areas: No matters have come to our attention that would require us, under professional standards, to inform you about (1) the methods used to account for significant unusual transactions and (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2009.

Estimates: Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The most sensitive accounting estimates affecting the financial statements are depreciation and compensated absences.

Management's estimate of the depreciation is based on useful lives determined by management. These lives have been determined by management based on the expected useful life of assets as disclosed in Note 4. We evaluated the key factors and assumptions used to develop the depreciation estimate and determined that it is reasonable in relation to the basic financial statements taken as a whole.

Accrued compensated absences is estimated using accumulated unpaid leave hours and hourly pay rates in effect at the end of the fiscal year. We evaluated the key factors and assumptions used to develop the accrued compensated absences and determined that it is reasonable in relation to the basic financial statements taken as a whole.

Disagreements with Management: For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the City's financial statements or the auditor's report. No such disagreements arose during the course of the audit.

Management informed us that, and to our knowledge, there were no consultations with other accountants regarding auditing and accounting matters.

Retention Issues: We did not discuss any major issues with management regarding the application of accounting principles and auditing standards that resulted in a condition to our retention as the City's auditors.

Difficulties: We encountered no serious difficulties in dealing with management relating to the performance of the audit.

Audit Adjustments: For purposes of this communication, professional standards define an audit adjustment, whether or not recorded by the City, as a proposed correction of the financial statements that, in our judgment, may not have been detected except through the audit procedures performed. These adjustments may include those proposed by us but not recorded by the City that could potentially cause future financial statements to be materially misstated, even though we have concluded that the adjustments are not material to the current financial statements.

We did not propose any audit adjustments that, in our judgment, could have a significant effect, either individually or in the aggregate, on the entity's financial reporting process.

Uncorrected Misstatements: Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. We have no such misstatements to report to the audit committee.

This report is intended solely for the information and use of the audit committee, City Council, and management and is not intended to be and should not be used by anyone other than these specified parties.

Mare & Associates

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